allocation methodology for LEC video investments to ensure that captive telephone ratepayers do not fund video networks.

C. The Productivity Factor Must be Set at Zero to Reflect the Unsettled State of, and the Commission's Relative Inexperience with, Current LEC Video Offerings.

The Commission correctly indicates in the *Notice* that "[s]election of a reasonable productivity factor for a video dialtone basket is crucial to ensuring that price cap regulation of this service would be efficient and fair . . . ."[46] The Commission originally included a productivity factor in the calculation of LECs' price cap indexes (PCI) to ensure that rates would continue to decline over time in relation to the measure of inflation factored into the PCI by the Gross National Product-Productivity Index (GNP-PI) variable.[47] The Commission also tied a rate-of-return enforcement mechanism called "sharing" to the productivity factor to spur LECs to be more efficient.[48] The sharing mechanism required that, if LECs failed to meet their productivity challenge (*i.e.* reported earnings that exceeded a targeted rate-of-return) they would incur a "sharing" obligation. Accordingly, the overearning LEC would have to reduce its PCI by an amount commensurate with overearnings to "share" its overearnings with ratepayers in the subsequent reporting year.

46/ *Notice*, at ¶ 14.

47/ *See LEC Price Cap Order*, 5 FCC Rcd at 6796.

48/ A LEC that is under a 3.3 percent productivity factor, for example, would be required to share with its customers half of its earnings between 12.25 percent and 16.25 percent, and all of its earnings in excess of 16.25 percent. *See LEC Price Cap Order*, 5 FCC Rcd at 6788, 6801-02.

The Commission initially set the price cap productivity factor at 3.3 percent for interstate access baskets on the basis of two Commission staff studies investigating the extent to which LEC productivity in the provision of interstate services historically had outperformed the economy as a whole.[49/] A 0.5 percent Consumer Productivity Dividend was also added (to arrive at a 3.3 percent productivity factor) to ensure that the first price cap productivity gains would be assigned to customers in the form of lower rates.[50/] The Commission also originally provided LECs with the option of electing a higher productivity factor of 4.3 percent in exchange for allowing LECs to keep a greater share of their earnings.[51/]

Because of the controversial history of the productivity factor, as well as the radically different nature of LEC-provided video programming over LEC-owned video facilities from any other telecommunications trends reflected in existing productivity factors, the Commission has no basis for adopting a productivity factor for any price cap basket it may establish for LEC video offerings. First, because a LEC that provides video programming directly to end users is a cable operator subject to Title VI, regulatory parity and competitive equity mandate that the same rules apply uniformly to cable operators and LEC video service providers. As the Commission correctly indicates in the *Notice*, it has

49/ The "Frentrup-Uretsky" study examined interstate access trends from the years 1984 through 1990. The "Spavins-Lande" study reviewed interstate access trends from the years 1930 through 1989. *See Notice*, at ¶ 15; *see also LEC Performance Review Order*, at ¶ 201.

50/ *See Notice*, at ¶ 15.

51/ A LEC that chooses the more challenging 4.3 percent productivity factor does not have to share any of its earnings unless they exceed a targeted rate-of-return of 13.25 percent, rather than the 12.25 percent rate-of-return targeted to the sharing zone applicable to LECs operating under a 3.3 percent productivity factor. *See LEC Price Cap Order*, 6 FCC Rcd at 6788, 6801-02.

declined to include a productivity offset in the price cap formula applicable to cable television rates.[52] In the *Cable Productivity Order*, moreover, the Commission's observation with respect to its conclusion that no productivity factor should be adopted for cable operators is directly relevant to the instant proceeding:

> [a] productivity offset should be based to the extent possible on observed efficiency gains experienced by the cable industry . . . . In adopting a productivity offset in other contexts, the Commission has had the benefit of numerous Commission-sponsored and independent economic studies, each providing a record of the historical costs and productivity of the relevant industry.[53]

The LECs are not yet past the prototype stages in their video ventures. That being the case, the Commission cannot reasonably conclude that it "had the benefit of numerous" studies or compiled a "record of historical costs and productivity" with respect to LEC video offerings sufficient even to begin to target a theoretically correct productivity factor.

Second, the difficulty in setting a new "interim" productivity factor evidenced in the recently released *Performance Review Order* emphasizes the many weaknesses of this theoretical variable.[54] Under the interim plan adopted in the *Performance Review Order*, LECs can now choose from among three productivity factors of 4.0, 4.7 and 5.3 percent.[55] Sharing obligations still apply under the interim plan to LECs that opt for either of the two

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52/ *Notice*, at ¶ 15 n.40, *citing Implementation of Sections of the Cable Television Consumer Protection Act of 1992 -- Rate Regulation*, Memorandum Opinion and Order, 9 FCC Rcd 5760 (1994) (*Cable Productivity Order*).

53/ *Cable Productivity Order*, 9 FCC Rcd at 5761.

54/ *See LEC Performance Review Order*, at ¶¶ 97-234.

55/ *See id.*

lower productivity factors. LECs choosing the 5.3 percent productivity factor have no sharing obligation. Even more important, the Commission determined that its original selection of a 3.3 percent productivity factor for LEC interstate access baskets was erroneous because a data point from the Frentrup-Uretsky study should have been excluded.[56] An observed rapid rise in LEC earnings suggested that the 3.3 percent productivity factor indeed may have been too low, and the Commission thus concluded that the productivity factor needed to be increased from 3.3 percent to 4.0 percent.[57]

In sum, the Commission's own experience with the existing productivity factor for LEC interstate access rates demonstrates that price caps are premised on assumptions not always exact and sometimes erroneous. Commissioner Ness, in her dissenting statement in the *LEC Performance Review Order*, correctly stated that the sliding scale of productivity factors in the interim price cap plan would "shortchange[] the interests of consumers" and the:

> consequence of these features of our interim plan is to reduce consumer benefits, increase uncertainty in the marketplace, and add unnecessary complexity to the framework. A far better approach would have been to change the structure less and the numbers more.[58]

The Commission must therefore set any productivity factor it chooses to adopt for a LEC video services price cap basket at zero. The history of the Commission's existing LEC productivity factor, albeit based on thorough and long-range economic studies, dictates

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56/ *See LEC Performance Review Order*, at ¶ 208.

57/ *See id.*

58/ *See LEC Performance Review Order*, Dissenting Statement of Commissioner Susan Ness, at 1-2.

that the Commission cannot do otherwise than to conclude that, in light of the comparatively minuscule record on the economics of LEC provision of video programming and facilities, only a productivity factor set at zero would make any logical sense. The Commission's decision not to adopt a productivity factor for cable services in the *Cable Performance Order* buttresses this conclusion.

D. There Should Not be Unified Sharing Across Baskets, Especially with Respect to the Creation of a Separate Basket for LEC Video Services.

If the Commission persists in treating some portion of the LEC video network as a Title II service and adopts a price cap basket, it also must limit the LECs' ability to cross-subsidize by establishing that there will not be any unified sharing across baskets. In the original LEC price cap proceeding, the Commission retained features of rate-of-return regulation in the form of a sharing and low-end adjustment mechanisms because it was concerned that the price cap formula might not prove to be perfectly accurate either for the LEC industry, individual LECs or market conditions.[59] The sharing mechanism requires LECs that earn in excess of a targeted rate-of-return (such as 12.25 percent for LECs with a 3.3 percent productivity factor) to "share" those overearnings with ratepayers in the subsequent reporting period by reducing their price cap indexes by an amount reflecting overearnings.[60] The low-end adjustment mechanism entitles a LEC that earns below a

59/ *See Performance Review Order*, at ¶ 166.

60/ *See LEC Performance Review Order*, at ¶¶ 167-71.

targeted rate-of-return of 10.25 percent to increase its PCI in the subsequent reporting year retargeted to a 10.25 percent rate of return.[61/]

Because sharing and low-end adjustments are based on total interstate earnings across baskets and are allocated among all of the price cap baskets, even though productivity gains within an individual basket may differ, the LECs have the opportunity and incentive to manipulate these rate-of-return mechanisms to engage in cross-subsidization. Indeed, MCI aptly observes that:

> the interstate sharing mechanism within the price cap rules incents the LEC to use overearnings as an offset for increased investment and expense rather than to share with captive ratepayers.[62/]

That LECs may use the sharing adjustment to misallocate costs and thereby cross-subsidize video ventures with revenues generated by captive ratepayers of less competitive services is not merely a theoretical concern.

The *LEC Price Cap Order* required that a sharing obligation be based on total interstate earnings, and that it be reflected in the PCI for each basket on a cost-causative basis.[63/] In implementing this requirement, the Common Carrier Bureau established in the *1992 Annual Access Order* that carriers should allocate sharing obligations on a cost-causative basis and found that basket revenues could be used as a proxy for basket costs.[64/] The

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61/ *See id.*

62/ *See* Comments of MCI, at 8 (filed March 21, 1995) in *VDT Fourth Further Notice*.

63/ *See LEC Price Cap Order*, 5 FCC Rcd at 6805.

64/ *See* 1992 Annual Access Tariff Filings, CC Docket No. 92-141, 7 FCC Rcd 4731, 4732-33 (Com. Car. Bur. 1992) (*1992 Annual Access Order*).

Bureau subsequently investigated several price cap LECs for allegedly failing to include their subscriber line revenues in allocating their sharing obligation across baskets on a "cost-causative" basis.[65/] Given the questionable manner in which LECs historically have allocated sharing obligations across baskets, it is more than likely that a LEC offering video programming and related video facilities under a separate price cap basket would have a strong incentive to continue improperly to withhold sharing allocations from captive telephony ratepayers and use the overearnings to fund video programming investment.

Because the sharing adjustment mechanism provides LECs with another opportunity to game the price cap system, there should not be any unified sharing if the Commission establishes a separate price cap basket for LEC video services. By isolating the effects to the separate price cap basket for video services, a non-unified sharing requirement would mitigate the possibility that LECs would otherwise exploit the sharing mechanism as a form of cross-subsidy.

V. CONCLUSION

For the foregoing reasons, the Commission should regulate LEC video programming as what it truly is -- cable service over a cable system subject to Title VI. If the Commission insists, however, on establishing a separate price cap basket for LEC video offerings, it must plainly identify what types of investments belong in that basket and ensure that any price cap basket established for LEC video offerings meets the following criteria: (i) a Part 64 cost allocation methodology must be employed between LEC video networks and

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65/ *See 1993 Annual Access Tariff Filings*, CC Docket No. 93-193, 8 FCC Rcd 4960, 4966, 4973-75 (Com. Car. Bur. 1993); *1994 Annual Access Tariff Filings*, 9 FCC Rcd at 3713-15.

LEC telephony investments; (ii) the productivity factor associated with such a basket must be set at zero; and (iii) there should be no unified sharing across the video basket to any other baskets. These additional protections are essential to establish regulatory parity between similarly situated LECs offering video services and cable operators and to protect LEC telephony ratepayers from massive cross-subsidies.

Respectfully submitted,

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